DOW THEORY LETTERS INC.

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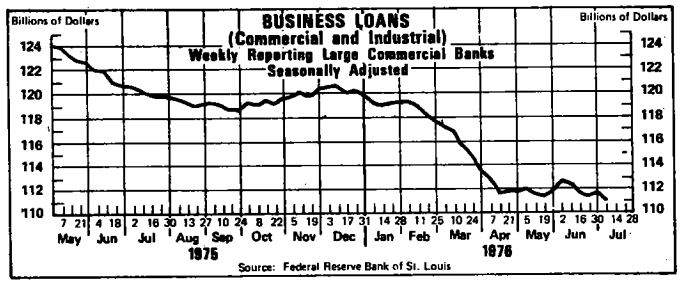
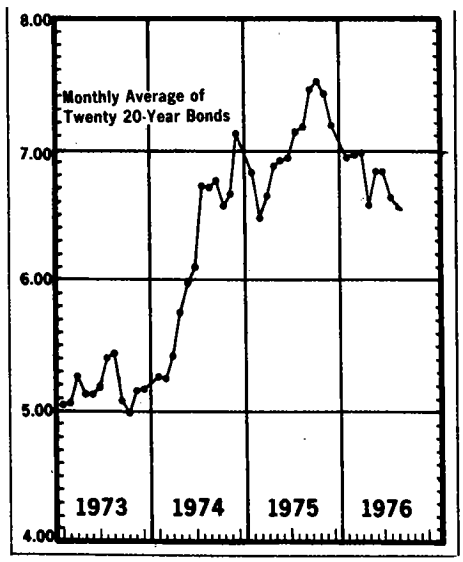
July 30, DJIA 984.64; PTI 654; A-D Ratio -22.93
Aug. 6, DJIA 986.00; PTI 663; A-D Ratio -22.66

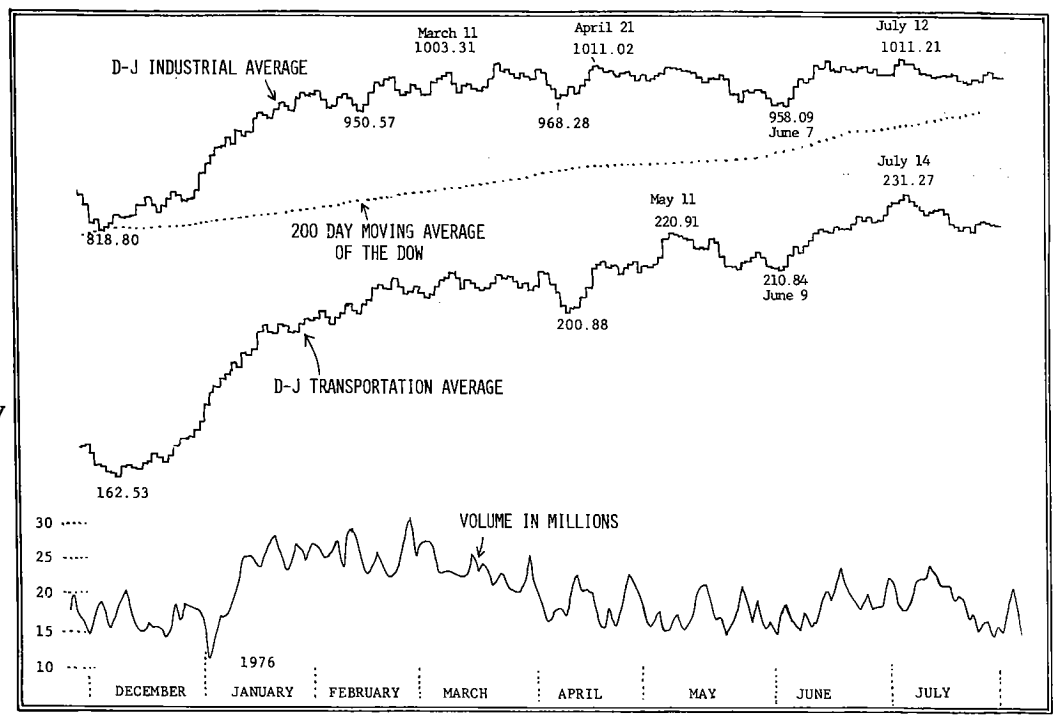

BUSINESS LOANS
(Commercial and Industrial)
Weekly Reporting Large Commercial Banks
Seasonally Adjusted
Billions of Dollars
Billions of Dollars
124
122
120
118
116
114
112
110
7 21 4 18 2 16 30 13 27 10 24 8 22 5 19 3 17 31 14 28 11 25 10 24 7 21 5 19 2 16 30 14 28
May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul
1975
1976
Source: Federal Reserve Bank of St. Louis

DRAMA: Let's try to put the pieces of the puzzle together. (1) Commodities have been doing a swan dive (see chart in the last Letter). (2) The prices of gold, silver, and gold shares have continued to sag. (3) The money-sensitive D-J Utility Average hit a new bull market high on August 2. (4) Perhaps this chart from the WSJ says it all. What we see here is an inverted bond yield chart for 20 assorted Municipal bonds. The head-and-shoulders pattern on the chart suggests a crack to the downside. If that happens, Muni interest rates will sink below the 6.5% level, signalling higher bond prices and declining interest rates across the board. In other words, I believe this chart is about to issue a "bull signal" for bonds, and my guess is that bonds of all shades and varieties are about to advance to higher levels.



Why, what's the reason behind the strength in bonds? The reason is that liquidity is building up, business is rather sluggish, loans are down (see chart), consumer enthusiasm is subsiding and inflation is leveling off. This turn of events is probably long-term bullish for the stock market, but near-term it is confusing. Rising liquidity is a bullish factor for stocks, but sluggish business constitutes a temporary detriment. Stocks could move higher on a selective basis, but the Advance-Decline Ratio (representing the broad list of all NYSE stocks) has been resisting. At the same time, no real selling pressure has come into the market—yet.

My conclusion: the safest and best common stock holdings at this time are those which are money and interest-rate sensitive; stocks such as AT&T, the Utilities in general, Transamerica, selected banks, etc. But probably the top values in the securities markets these days (and I've said this dozens of times) are bonds. Individual bonds, bond funds, Municipal bonds and funds, closed-end bond funds. I don't believe the current high yields on bonds are going to last; I think bond yields are going lower and bond prices are going higher—and soon.



1976: In recent Letters I've noted that the public is exiting from this market to the tune of at least $100 million per week. The money has been coming out of the mutual funds, which are being redeemed at a whopping rate. And it is coming from odd lot sales, which have held far above odd lot purchases during 1976. We know where the money is coming from, but where is it going? My guess is that part of it has been going into the banks, part has been going to pay for living expenses, and part has been going to bonds and various high-yielding forms of saving vehicles.

I include this clip from last week's newspaper because it shows that the public doesn't have to go very far to find bargains. Here's Uncle Sam offering his debt to yield a fat 8% over ten years. And guess what? It was all packaged like candy bars for Joe and Jane America, in $1, 000 lots so that any mini-capitalist could afford one. The news was that the 8's were triple over-subscribed and sold two days later at a premium of 2%.

A WALL STREET JOURNAL *News Roundup*

Investors ordered a staggering $24.37 billion of the Treasury's new 8% notes, about six times more than the $4 billion it had offered through Wednesday, the department announced last night. About $7.6 billion of the orders were accepted, it added.

In anticipation of the enormously successful sale results, those fresh 10-year notes were marked up sharply in unofficial resale trading earlier yesterday, dealers reported. They were quoted at about 101 5-32, the equivalent of about $11.25 for each $1,000 face amount above their original price of 100. The higher resale price reduced their yield to about 7.85% from the 8% initially.

Meanwhile, Mr. Klein, Jimmy Carter's economist, has stated that President Ford's business scenerio is a bust. Klein estimates that it will require an additional $12 billion of deficit spending to put us back on the road to prosperity. While Mr. Ford searches for a running mate, Ronald Reagan upset the Republican conservatives by choosing a party liberal for his VP. Probably the best market-oriented comment on the whole situation was furnished by Eliot Janeway last week when he wrote, "The political test of market confidence: it's critical—more so than any of the accepted economic tests represented by earnings, dividends, the level of the economy or the rate of recovery. The market is floundering because it doesn't know how to read the political headlines. If Carter is a market threat, a Ford win scarcely represents a bullish alternative (any more than a Reagan win does)."

THE PICTURE: All right, so much for Carter, Ford, Reagan and money rates. The question on all our minds is, "Where are we as far as the stock market is concerned?" And this is the way I see it. The primary trend of the market remains bullish. The secondary trend must be rated as obscure.

Why do I feel uneasy? Why did I suggest in the last Letter that we cast off weaker issues, boost our bond percentage, move in to a more defensive position? I'll go over my thinking once again, while updating the whole picture based on the market action of the last ten days. First, we have a 1976 high in the Advance-Decline Ratio, a high recorded on February 24 (see chart). Then, five months later, in mid-July, we witnessed peaks in the D-J Averages. Industrials hit their high on July 12 at 1011.21, Transports established their peak on July 14 at 231.27.

Maybe I'm nervous, and maybe I'm prone to worry. But I've always been leary of extended periods in which the A-D Ratio refuses to confirm new highs on the Dow. Furthermore, I've never liked periods in which the D-J Averages record seemingly significant highs in July or August.

My dislike for long lag non-confirmations in the A-D Ratio is easy enough to explain. Such non-confirmations have a habit of heralding trouble. We saw long lag non-confirmations (i.e., new highs in the Dow recorded many months after a high in the A-D Ratio) in 1919, 1929, 1947, 1957, 1959, 1961, 1965 and 1972. Most of those examples proved exasperating at best, very costly at worst. The lone exception was 1963, and even there the situation brought on problems. True, the Averages advanced to peaks in early 1966, but the A-D never did get substantially above the June 1963 high.

My dislike for July or August peaks in the Averages is slightly more difficult to justify. Starting with the year 1943, we had a July peak that year followed by a long decline into 1948. In 1947 a July peak produced a five-month decline. July-August peaks in 1948 were followed by a one-year decline. In 1956 we had July-August peaks which set off a severe, six-month decline. July peaks in 1959 provided the signal for a sharp, four-month decline. Last year (1975) we saw July peaks followed by a reaction which carried into December.

On the other hand, July peaks in 1944 touched off a mild two-month decline, but the decline was followed by two good market years. And in 1968, July peaks gave way to August lows, and then a big move into 1969. On balance, however, I do not like the fact that the current market has produced a "double trouble" effect in that a February top in the A-D Ratio was followed by July peaks on the D-J Industrial and Transportation Averages.

Referring to the page 1 daily chart of the D-J Averages, note that the bull market highs were recorded a few weeks ago, Industrials on July 12 at 1011.21, Transports on July 14 at 231.27. Following those peaks, an eleven trading-day decline took Industrials back to 979.29, Transports to 220.68 (both on July 29). From that low, the Averages pushed gingerly higher, then rallied strongly on August 3. From that point on, the market turned indecisive, with breadth tending to sink.

Since July 12, the Industrial Average has been sliding at a rather gradual rate, and currently the Dow is about 4% above its 200-day moving average. It is true that many corrections have terminated with the D-J Industrial Average at or below its 200-day moving average, and we will just have to let the market tell its story in its own good time. My own nervousness has to do with the thought that the market is moving towards a situation where it is going to find it very difficult to "straighten itself out" when the next real rally arrives.

Turning to the composite chart (page 3) of the Dow Industrials and the three indicators which we watch closely, I must say that in the five years since I first developed the Primary Trend Index (PTI), I have never seen this index diverge so dramatically from the A-D Ratio. The PTI (which is an amalgam of eight critical indices) set a bull market high of 658 on July 14. Following that, this index backed and filled, but on August 3 the PTI jumped to a new bull market peak of 660. On August 4 the PTI registered another new high of 667.

Turning to the A-D Ratio, this indicator has been a trouble-maker for the past five months. The A-D recorded its bull market high on February 24. Next, it declined to June 7, then rallied into July. On July 14 the A-D advanced to within a fraction

(actually 13/100's) of its February 24 peak. During the next two weeks the A-D dropped 1.29 points to a July 29 low.

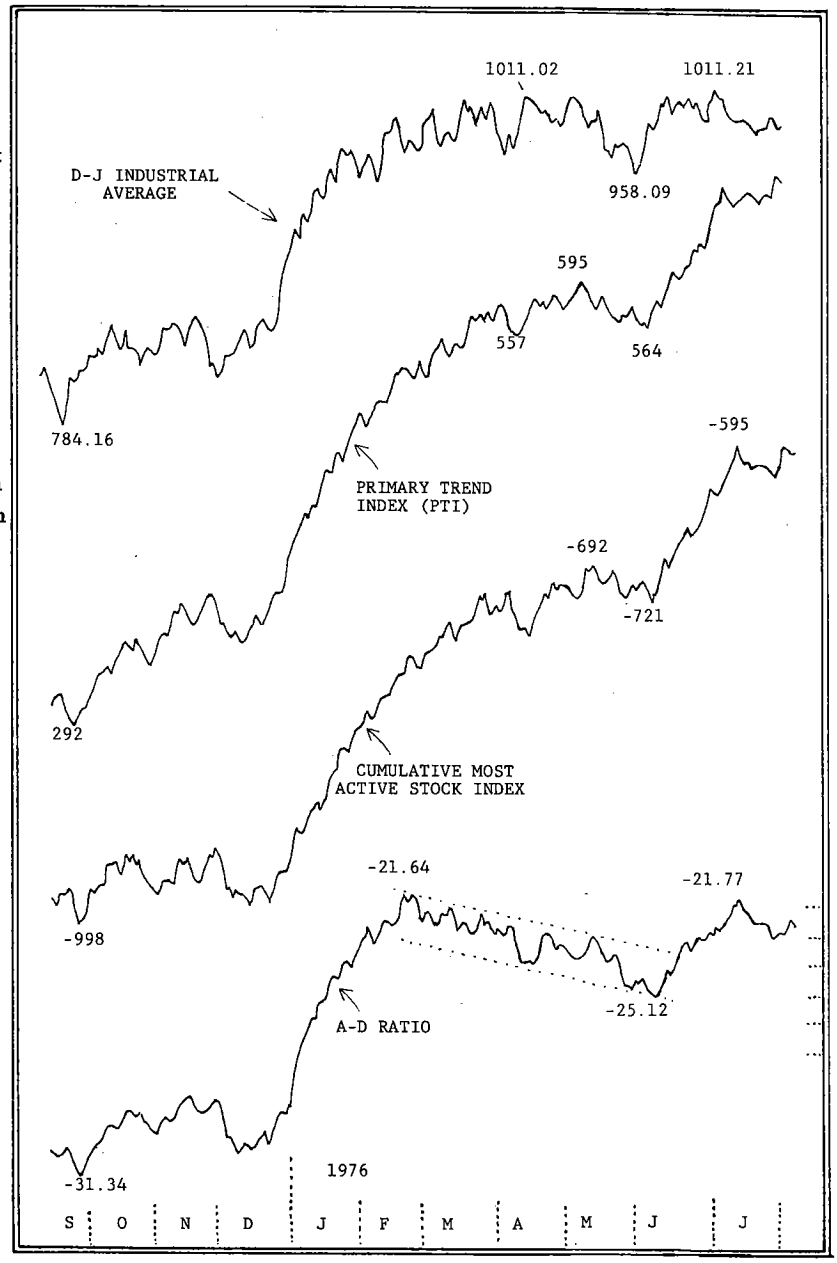
Over the years I have concluded (from my own observations) that any decline in the A-D Ratio of one point or more can be significant. Since the A-D failed to better its February 24 high and since it subsequently gave up over a point, I have watched the developing situation with some apprehension. I continue to hope that the A-D will confirm on the upside. The fact is that so far it has not.

Overall, we now have a number of interesting but confusing factors to deal with in the market. (1) The D-J Industrials and Transports, having rallied to new bull market highs in mid-July, failed to follow through on the upside. Instead, they sank to July 29 lows, then rallied again in a rather half-hearted manner. This is disconcerting, but it does not constitute sufficient reason to turn bearish on the secondary trend (it is a reason for caution, however).

(2) The PTI has been very strong, but the A-D Ratio (in a rare instance of divergence) has refused to confirm the bullish reading of the PTI. This too, is a reason for caution.

(3) The cumulative most-active stock index (see chart) has continued strong. This action reflects a concentration of buying in selected issues. In the past the A-D has tended to follow the path of the CMAS, but so far this has just not happened.

(4) On August 3 the D-J Utility Average rallied above its old February 4 peak of 91.90. Thus, it recorded a new bull market high. This is a strong plus for Wall Street. The plus factor is fortified by the continuing strength in the bond market. It should be understood, however, that the strength in Utilities is a plus, not a guaranteed bullish signal for the stock market (for instance, all during the first half of 1960 the Utilities headed up while the rest of the market slid away).



CONCLUSION: The primary trend is bullish. The secondary trend is obscure. While caution is warranted (and I have advised caution), the benefit of the doubt must still be accorded the bulls.

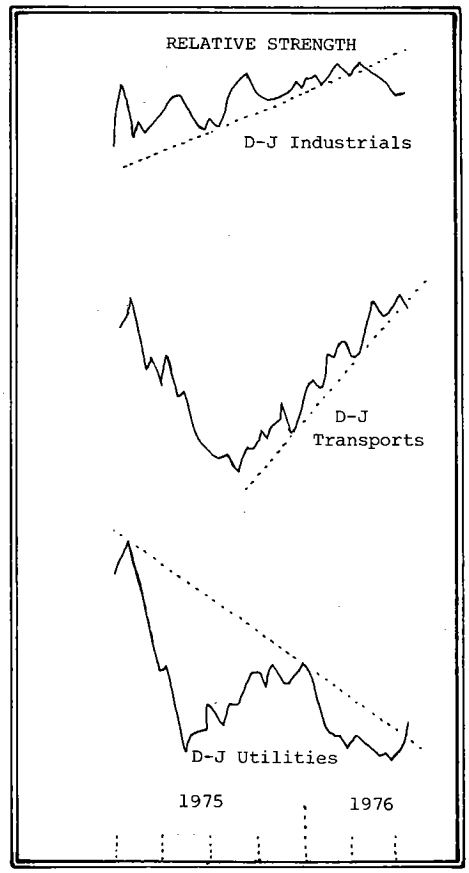
The Utility Average is at or near its bull market hi gh. The Industrial and Transport Averages are milling about indecisively, but they have traced downward zig-zag patterns since their mid-July highs. The strength of the PTI is undeniable. The A-D Ratio is flashing a yellow caution signal. My reading of the situation is that the market is being very cautious. Why should we act any differently!

At this point I want to include a chart (page 4) showing the relative strength (RS) of the three D-J Averages measured against the NYSE Composite. First, note that the Industrial Average has turned down in RS, indicating that it is not keeping up with the general market. This action should not be taken bearishly. It simply means that the broad list of NYSE issues are acting (on a trend basis) better than the Dow Industrials.

The Transportation Average has been portraying superior RS since mid-1975, but this phase now appears to be ending. I would classify the Transport RS as neutral at this point, but probably on the verge of turning down.

Most interesting to me is the breakout in Utility RS, a phenomenon which I have been drawing attention to in recent Letters. This should be a plus for the general market, and it certainly indicates a favorable reading for the Utility stocks at this time.

TACTICS: A bull market usually provides at least one and sometimes two good "buy spots" each year. The last advantageous buy spot in this bull market occurred in mid-December, 1975. We have not really had a good buy spot so far in 1976. The market has been indecisive for the past five months, and I feel increasingly that one of two factors must occur if investment "big



money" is to be brought into this market in an impressive way. (1) Earnings and dividends on common shares will have to make a dramatic leap upward, a leap of more impressive proportions than anything the market is now visualizing or discounting. Or (2) we will have to have a market decline large enough so that investors feel that stocks are once again in a "buying" or "bargain" area.

Personally, I suspect that the market has gauged forthcoming earnings and dividends fairly accurately. I doubt whether the market is going to be "happily surprised" by a surge of unexpectedly good news on the earnings-dividend front. Consequently, I believe there is a fair to good chance that before 1976 is out (regardless of who wins the election) we are going to have a decline of sufficient proportions to produce an oversold market, and a decline large enough to bring today's reluctant investors back into the market in an important way.

WEALTH: The current issue of Town & Country magazine contains a most interesting article about Britain and the effects of the "wealth tax" (which is being proposed but has not yet become law). Interviews with a number of wealthy Britains are included in the article. The picture is clear enough. The wealth tax will be an annual tax, not on income, but on assets. This new tax will slowly but relentlessly erode the personal fortunes of England.

The great individual art collections, the family estates, the private museums, the great and medium-sized land holdings, all these will ultimately be chewed up and digested by the government. Thus the wealth of Britain is disappearing first via the inroads (we should probably call it the "thievery") of inflation, and then by the proposed wealth tax (which will serve to confiscate anything that remains after inflation).

I have been studying the British situation carefully, and I have been wondering how far behind the US can be. Money magazine has just published the IRS figures covering income and tax returns in the US. The figures make astonishing reason. For instance, only .2% of the income tax returns are from US citizens making from $100 thousand to $500 thousand per year. And only .8% of the returns show incomes of $50 to $100 thousand. Now note this. A fat 25% of the returns show incomes of from $5,000 to $10,000 and 31.5% show incomes under $5,000 (the under-$5,000 add up to 26.8 million individual returns!). In other words, one-third of the votes and more are in the low-income groups. And therein lies the wave of the future.

I don't make that statement lightly. But I'll repeat it again, the low income groups have the votes, and only votes make politicians move off their fannies. Here is a bit of the proof as to where the money is going. Since 1966 the national defense budget has risen 66% to $99 billion. But since 1966 the human resources (HUD, welfare, etc.) budget is up 378% to $198 billion. The money goes where the votes want it to go.

All right, what can we conclude from all this? Here are my own conclusions. (1) The price of all sorts of collectibles are now "through the roof". I just went through the Hemmings Motor News catalogue, and the price of classic cars is literally out of sight. Barron's this week has an article on porcelain and the new price boom. Stamp prices, coin prices, antique prices, art prices, they're all going skyward.

But none of these collectibles bring in income. The collectibles have risen in price, and they can also go down. If they go down, there could be a rush to get out which would hit prices hard. Some of the big British collectors are already talking about dumping their art in order to raise money if the wealth tax is enacted. Thus, my conclusion here is that collectibles are fascinating and have been profitable, but we could also be nearing some kind of top in the price of "things."

(2) The big push in the period ahead may be for income, steady income, and dependable income. The safest, cheapest high-income vehicles at this time would appear to be good bonds. Although bonds do not have the inflation hedging properties of common stocks, it is also possible that inflation itself could be topping out (at least for a while). What I am saying is that with the rise of taxes and a leveling off of inflation, the bond may finally be coming into its own.

(3) The big "kicker" behind bonds (aside from a potential cessation of inflation) is the new deferred income concept; the deferred annuity, the Keogh plan, the corporate pension plan, the profit sharing plan. All of these can utilize the fantastic advantages of compounding interest rates. I do not believe the public (or most money managers, for that matter) fully comprehend the power of compounding. I urge all my subscribers who have not already done so to go to their local book store and purchase a booklet on compound interest tables, then take off a few hours and study what compounding will do for money (at say, the-easy-to-obtain 8% interest rates).

(4) When rising quantities of money chase a fixed or diminishing quantity of goods, we have inflation. When purchasing power diminishes in the face of an increasing amount of goods we have deflation. I believe that we could now be in that subtle area midway between inflation and deflation. True, there are still many inflationary breezes blowing, but there aren't any inflationary headwinds any longer; they're just breezes. There are also new winds blowing, and those new winds are deflationary. So my

advice is — don't buy anything or do anything purely on the basis of inflationary expectations. My guess is that the tides of inflation are about to recede.

Writing on the same subject in the latest Bank Credit Analyst, 1245 Sherbrooke St. W., Montreal 109, Canada, editor Tony Boeckh notes: "Since our contemporary money and credit inflation has lasted several decades, obviously a change in the underlying forces is not going to take place overnight. It will take many years to come about. The transition from an inflationary period to a deflationary one is bound to be a complex process, involving many financial crosscurrents that will give a confusing appearance .....The one and a half year period since the peak in commodities and interest rates and the trough in equities is a very brief period given the inflationary momentum that has built up over past decades, but already the various financial markets are taking on the characteristics that might be expected at the initial state of the transition period."

THE OBVIOUS: A great deal of understanding can be acquired by examining the obvious. There aren't too many things I personally take for granted. That may appear to be a cynical attitude, but it also leaves one open to new ideas, new ways of perceiving things and new ways of thinking.

In the stock market everyone talks about trendlines, but few people ever take the time to mull over what a trendline actually is. What does establishing a trendline mean? What does holding a trendline or breaking a trendline imply?

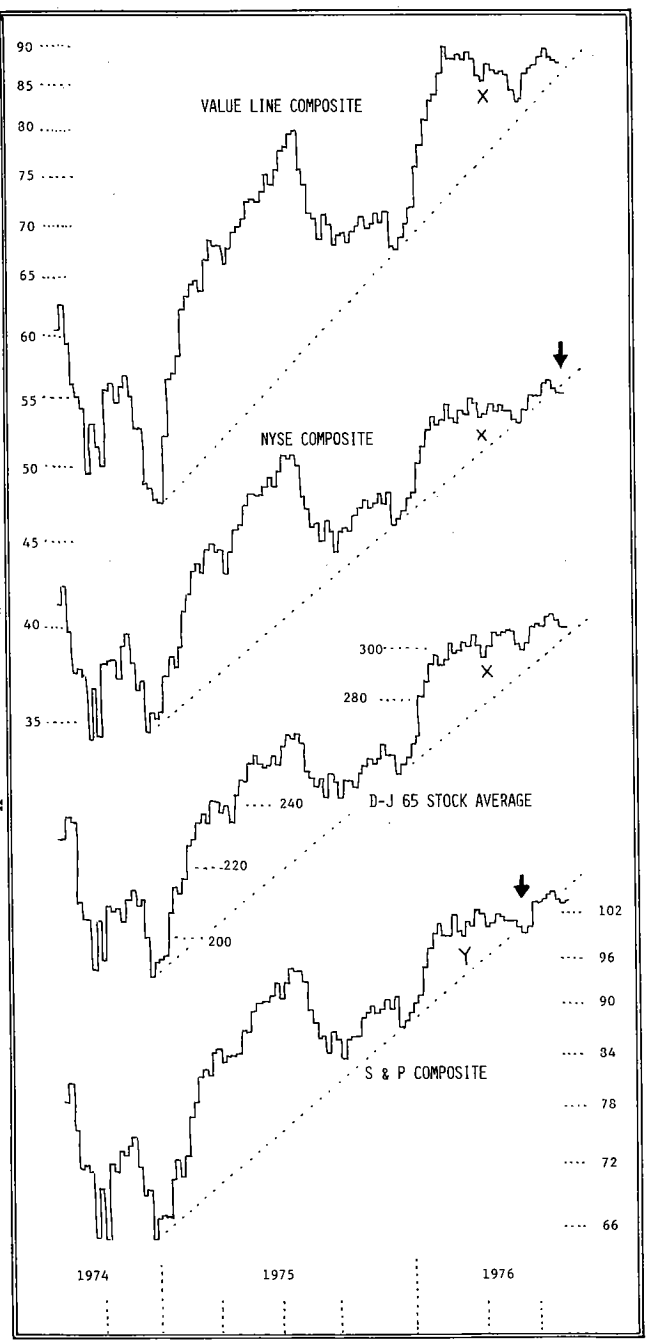
Ratio scale (semi logarithmic scale) chart paper deals with percentages. When you draw a trendline on ratio scaled chart paper, you are drawing a line which traces a steady rate of increase or decrease. This is why trendlines are so much more important when drawn on ratio scale compared with trendlines drawn on arithmatic scale.

Consider a stock chart. When a number of rising bases are connected during a generally rising price movement, we can say that the resultant trendline is defining a rate of growth. The steeper the rising trendline, the steeper the growth rate or rate of ascent. We can also say that as long as the stock holds on or above the rising trendline, that growth rate is being maintained. When the trendline is ultimately broken, we can say that (1) a new shallower growth rate is in process, or (2) the whole rising trend may be over, and a declining trend may be getting under way.

In Letter 669 I included a chart of four of the major composite stock Averages that I follow. I noted at the time that the valid market moves the important market moves, are always visible on all of the composite Averages. For instance, you never have a major decline in the D-J 65 without an important decline in the Value Line Composite or the S&P 500. It just doesn't happen. Therefore, I watch all four of these important composites for signs or signals of continuation or reversal of the trend.

Since Letter 669, we have had a few subtle changes in two of the composites, and I want to bring this to the attention of subscribers (particularly since the market is now so difficult to interpret, and we need all the help and understanding we can get.)

I have drawn rising trendlines on each of the composites. These trendlines delineate the "growth rate" of the respective Averages in this bull market. Note that on the week ending June 4 the S&P 500 broke below its trendline. This Average then rallied, but on June 23 it fell below the trendline again, and the 500 is definitely holding below the trendline as of this writing.



On August 6 the NYSE Index (1644 common stocks) edged below its rising trendline, and the week ending August 13 saw the NYSE Index again moving sideways below the trendline.

Currently the D-J 65 Stock Average is about 5 points above its trendline, and it would have to fall to about 305 to break the trendline. Value Line's broad Composite (1650 stocks on the NYSE, the AMEX and Over-The-Counter) is still comfortably above its trendline. Note also that the Value Line trendline has by far the steepest (rising) trendline of the four Composites.

From what I see so far on these composites, I would say that the rate of ascent for the great majority of stocks on all exchanges is now slowing down. If the Value Line and the D-J 65 come down and break their rising trendlines, we would then have confirmation from all four composites. In that case, the odds for a secondary reaction in the market would increase markedly.

A hard-nosed bear might say that this initial breaking of trendlines on the part of two of the four composites is spelling trouble and maybe the early crack-up of the whole bull market. That is simply not so. But it is true that the bull market is slowing down (and during earlier Letters this year I warned that this had to happen).

One reason the bull market is slowing down is that it moved up too rapidly during the December, 1974 to February, 1976 stage. The angle of ascent was too steep (see Letters 664 and 666). But whether something other than rate of ascent is bothering the market at this time we cannot tell. Our most important job, if you remember, is watching how the market is working, and then acting accordingly. As to why the market is acting this way or that, it's always an interesting question. But if we insist on knowing why before we act, we will end up as just another casualty on Wall Street. The reason for a market movement is usually known after the event, and in a great many instances, it is never known at all.

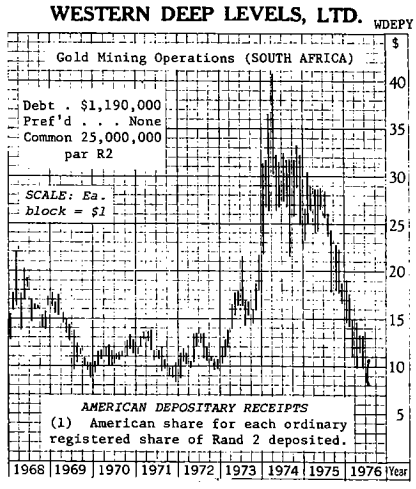
GOLD & SILVER: When the gold price started sliding in earnest a few months ago, there were many who advocated switching to silver. It was maintained that while gold was temporarily in trouble, silver was the true inflation hedge. I never agreed with this stand (as readers know), and so far my judgment has proved to be OK. Silver is now down about 18% from its recent June high of $5.05 and gold continues to loll around in the 112 to 115 area.

Everything in the market is timing. Today's villain is tomorrow's martyr. Today's enemy is tomorrow's ally. Today's fashion is tomorrow's abomination. And today's gold is a fallen idol. But tomorrow or next year or in 1984 gold will again be king. And men will be hoarding it and cursing the fact that they didn't buy it when it was near $100 back in 1976.

Modern gold coins are a survival vehicle, and unless you have all the answers I still suggest that you have around 5% of your assets in krugerrands or coronas. You should do this because then you can then tell yourself that you own some real money. Those gold coins will be money when your grandchildren's grandchildren are still trying to make dollars (or whatever they might call them in 2090) acceptable to themselves or the Russians or maybe the Martians.

As for the gold stocks, that's another story. The utter, total, sickening collapse in gold shares would seem to be telling us that some shockers are in store. Shockers such as a few mines closing down, or perhaps more political trouble in S. Africa. Incidentally, I read in the newspapers where the black street chants have changed from "No Afrikaan language in the schools" to "Freedom now." Quite a change, but then things happen fast today. No one seems to be able to perceive of change. It's true that most S. African blacks can't read, and they have very limited rights. But they are men, and men think. The winds of change are blowing fast today, and men can think. Those are the two underlying truths which S. Africa has to contend with, and I haven't got the answers for this troubled land (I really wish I did).

As far as we are concerned, as investors, the options are a bit clearer. The S. African shares are no longer investment vehicles. Dr. Harry Schultz once wrote that "There's many a slip between the gelt and the veldt." You'd better believe it, but the slips have grown into chasms. When we possess a piece of paper saying that we are the owners of 100 shares of Vaal Reefs, we don't really know what we have any more, and that's worrisome. I don't like speculating against the tides, and I feel the tides are too rough in S. Africa. Look at this chart of Western Deep Levels (courtesy of Horsey), and you know what I mean. Little economic reverses don't make charts like this, potential catastrophes do.



NEW ORLEANS: "New Orleans, land of dreams," the big one is coming up on Sept. 16, 17 and 18. It promises to be a fascinating, super get-together. I'm talking about the "1976 Gold and Monetary Conference" sponsored by the National Committee for Monetary Reform. I'll be there spouting my ideas along with 32 other speakers in what will probably be the largest meeting of its kind ever (attendance should be 800 to 1000). The speakers constitute a "monetary Who's Who," and they'll range from Finance Minister Harwood of S. Africa to John Exter, Donald Hoppe, Nicholas Deak, Jerome Smith, Jim Sinclair, Austin Barker, Ira Cobleigh, John Kamin, Big John McFalls, Dr. Elgin Groseclose, on and on.

The Committee has rented the entire Fairmont Hotel in Jazz City for the occasion (the whole trip is deductible for tax purposes). The price is $275 for a single, $450 per couple (rates go up after Aug. 25). For info and reservations write Nat'l Comm. for Monetary Reform, 1254 Hillary St., New Orleans, LA 70118 or call (504)865-9919. If you have never been to New Orleans, I would say it's an experience. The City comes alive around 9pm and just keeps going all night. New Orleans is unique, picturesque, and if you like to eat.....

LATE NOTES: For the first time since 1959, there has been a change in the DJIA. Anaconda is out and Minnesota Mining is in. I think it's a good change. The Dow has enough metal stocks, and it needs a growth oriented, research type issue. The market opened the new week with more uninspired action and there's little I can add to my previous comments. A market dribbling off on lack of bids will often gather sellers as it slides, and this is what I watch for. So far, based on what I see, I'd say play it carefully. Until the A-D confirms above the February peak, I'm not going to be in love with this market.

Next mailing: August 20.